

**DEPARTMENT OF STATE REVENUE  
LETTER OF FINDINGS NUMBER: 94-0893 ITC  
Gross Income and Adjusted Gross Income Tax  
For Tax Periods: 1985 and 1988 through 1992**

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**ISSUES**

**I. Gross Income Tax — Remanufacturing**

**Authority:** IC 6-2.1-2-2; IC 6-2.1-2-4; IC 6-2.1-2-5;  
IC 6-2.1-2-1; IC 6-2.1-2-5(9)  
*Chrome Deposits Corporation v. Indiana Department of State Revenue*,  
557 N.E.2d 1110 (Ind.Tax 1990)

Taxpayer protests the assessment of Indiana gross income tax on its sales of remanufactured rings.

**II. Gross Income Tax — Computer Software Maintenance Contracts**

**Authority:** IC 6-2.1-2-7

Taxpayer protests the assessment of Indiana gross income tax, at the high rate, on sales of computer software maintenance contracts.

**III. Gross Income Tax — Interstate Sales**

**Authority:** IC 6-2.1-3-3  
45 IAC 1-1-119

Taxpayer protests the inclusion of sales to customers outside the state of Indiana in its Indiana gross income.

**IV. Adjusted Gross Income Tax — Interstate Sales**

**Authority:** IC 6-3-2-2(e), (f), and (n)

Taxpayer protests the inclusion of sales to customers outside the state of Indiana in the numerator of its sales factor.

**V. Gross Income Tax — Intercompany "Corporate Charges"**

**Authority:** IC 6-2.1-4-6  
45 IAC 1-1-96; 45 IAC 1-1-17; 45 IAC 1-1-9; 45 IAC 1-1-10  
*Information Bulletin #23*

Taxpayer protests the assessment of Indiana gross income tax on “corporate charges” between taxpayer and its unconsolidated entities.

**VI. Gross Income Tax — Intercompany Charges Among Affiliated Group Members**

**Authority:** IC 6-2.1-4-6(a); IC 6-2.1-5-5(b)

Taxpayer protests the disallowance of deductible charges made among members of its affiliated group authorized to do business in Indiana.

**VII. Tax Administration — Penalty**

**Authority:** IC 6-8-10-2.1  
45 IAC 15-11-2; 45 IAC 2.2-3-20

Taxpayer protests the imposition of a ten-percent (10%) negligence penalty.

**STATEMENT OF FACTS**

Taxpayer is an Indiana corporation domiciled in Indiana. Taxpayer is also the parent corporation for numerous subsidiary companies. Consolidated federal returns (Form 1120) were filed for all members of the affiliated group. Consolidated Indiana returns (Form IT-20) were filed by all members of the affiliated group having nexus with, or authorized to do business in, Indiana.

## I. Gross Income Tax — Remanufacturing

### DISCUSSION

Taxpayer is engaged in several types of activities. Taxpayer *sells* new and remanufactured rings. Taxpayer *manufactures* new rings. And taxpayer *remanufacturers* used rings. Remanufacturing activities require taxpayer to obtain a supply of used rings. These rings are acquired from several sources. Taxpayer may purchase used rings from third parties. Taxpayer may also accept used rings as "trade-ins." The majority of the time, however, taxpayer receives its used rings from customers - not as trade-ins - but with instructions to remanufacture, and return, the originally supplied ring.

Slightly over one-half of taxpayer's income is generated by remanufacturing activities performed on used rings supplied by taxpayer's customers. These customers have chosen not to purchase remanufactured rings from taxpayer's existing inventory. Rather, they have asked taxpayer to remanufacture and return their originally submitted ring. Taxpayer explains, "[d]ue to the highly regulated nature of the ... industry, ... companies are required to track the 'life' of the parts that make up their [product]. As a result, some ... customer's require [taxpayer] to remanufacture a jet engine ring owned by [the customer] rather than trade in an old ring and purchase a new or used [remanufactured] ring."

Audit classified taxpayer's remanufacture of rings as a service activity. Consequently, Audit assessed all income received from these remanufacturing activities at the high rate for gross income tax purposes.

Taxpayer counters by arguing receipts from remanufacturing activities should be taxed at the low rate. Taxpayer reasons the sale of remanufactured rings constitutes selling at retail because the essence of the transaction is the replacement of the ring linings. Taxpayer analogizes its activities to that of the taxpayer in *Chrome Deposits Corporation v. Indiana Department of State Revenue*, 557 N.E.2d 1110 (Ind.Tax 1990); and concludes, consistent with the opinion in *Chrome Deposits*, that its activities are not service activities to be taxed at the high rate. Rather, as a manufacturer and retailer of ring linings, taxpayer believes its sales should be taxed at the low rate as receipts from selling at retail.

Indiana Code 6-2.1-2-2 imposes a gross income tax on the "entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana." This tax is imposed at two rates - the high rate (1.2%), and the low rate (.03%). Receipts from wholesale sales and from selling at retail are taxed at the low rate. IC 6-2.1-2-4. Receipts from service activities, and other business activities, are taxed at the high rate. IC 6-2.1-2-5.

The relevant language of IC 6-2.1-2-1(b)(1) provides:

"Selling at retail" means a transaction in which a retail merchant in the ordinary course of his regularly conducted business transfers the ownership of tangible personal property to another, conditionally or otherwise, for a consideration if:

(A) the retail merchant had previously acquired that tangible personal property for the purpose of reselling it; and

(B) the transferee acquiring the property does not acquire the tangible personal property for the purpose of making a wholesale sale.

Consistent with the above-mentioned language, taxpayer's sale of remanufactured rings *from inventory* qualifies as selling at retail. *However, when taxpayer's customers send in used rings and receive, in return, their original, remanufactured rings, receipts from these sales are not derived from "selling at retail."* Absent from these transactions is the requisite exchange of tangible personal property. The customers, throughout the entire remanufacturing process, have never relinquished title to the rings.

In the alternative, taxpayer argues that its remanufacturing activities should be characterized as industrial processing - income to be taxed at the low rate as wholesale sales. For gross income tax purposes, receipts from industrial processing are included in the definition of wholesale sales. The language of IC 6-2.1-2-1(c)(1)(D) broadens the definition of wholesale sales to include:

(D) Receipts from industrial processing or servicing, including:

(i) tire retreading; and

(ii) the enameling and plating of tangible personal property which is owned and is to be sold by the person for whom the servicing or processing is done, either as a complete article or incorporated as a material, or as an integral or component part of tangible personal property produced for sale by such person in the business of manufacturing, assembling, constructing, refining, or processing.

Taxpayer maintains that given the Indiana Tax Court's recent interpretation of IC 6-2.1-2-1(c)(1)(D)(ii) in *Jefferson Smurfit v. Indiana Department of State Revenue*, 681 N.E.2d 806 (Ind. Tax 1997), taxpayer's remanufacturing activities should be characterized as industrial processing.

The court in *Jefferson Smurfit* narrowed the scope of the industrial processing resale requirement. (See IC 6-2.1-2-1(c)(1)(D)(ii).) The court limited the resale requirement to only those engaged in "enameling and plating" activities. As taxpayer's customers do not resell the remanufactured rings, taxpayer now believes its remanufacturing activities should fall within the ambit of the industrial processing classification – a subset of wholesale sales.

However, regardless of moniker used – whether taxpayer rebuilds, repairs, refurbishes, or remanufactures – taxpayer's customers are not engaged in activities contemplated by the concept, or definition, of "industrial processing." Implicit in the concept of industrial processing is the notion that the owners of the processed property (i.e., taxpayer's customers) are engaged in manufacturing, processing, or similar activities. In this instance, taxpayer's customers are not engaged in these types of activities. Rather, taxpayer's customers are service providers.

The Department, therefore, finds that taxpayer is not engaged in industrial processing. Rather, taxpayer is providing a service. Taxpayer's income from these sales should be taxed at the high rate.

### **FINDING**

Taxpayer's protest is denied.

## **II. Gross Income Tax — Computer Software Maintenance Contracts**

### **DISCUSSION**

Taxpayer protests the assessment of Indiana gross income tax, at the high rate, on receipts derived from the sale of computer software maintenance contracts.

Company A, a member of taxpayer's Indiana consolidated group, is a value-added reseller of computer hardware and software. Company A bundles software applications with hardware equipment. The hardware and software packages are then resold. Company A also sells maintenance contracts. These contracts include software updates and technical service assistance. Audit found the receipts from sales of maintenance contracts represented service income. Consequently, Audit proposed an assessment of gross income tax on these receipts at the high rate. Taxpayer contends the low rate should apply.

Taxpayer argues that for Indiana gross retail tax purposes (sales tax) the Department treats software updates as tangible personal property. (See *Sales Tax Information Bulletin #2*.) From this, taxpayer infers that "the *gravis* of software updates is the transfer of tangible personal

property and not the rendering of services." Taxpayer reasons that since Company A is selling software updates through its maintenance contracts, and software updates are tangible personal property for sales tax purposes, receipts from the sale of software updates should also be taxed at the low rate for gross income tax purposes.

Taxpayer's maintenance contracts include both sales of services (technical service assistance) and sales of tangible personal property (software updates). Taxpayer fails, however, to segregate this service income (taxed at the high rate) from its income derived from sales of tangible personal property (taxed at the low rate). Consequently, because taxpayer fails to separate its gross income that is subject to different rates of taxation, "taxpayer's entire gross income is subject to the higher of the rates." IC 6-2.1-2-7(c).

The Department finds, therefore, that income from taxpayer's sales of computer software maintenance agreements was correctly assessed at the high rate for gross income tax purposes.

### **FINDING**

Taxpayer's protest is denied.

### **III. Gross Income Tax — Interstate Sales**

### **DISCUSSION**

Taxpayer protests the inclusion of certain sales receipts in the computation of its Indiana gross income tax.

Taxpayer classified many of its sales of computer software maintenance agreements as sales made in interstate commerce – sales to be excluded from its Indiana gross income. The maintenance contracts consist of two elements - technical assistance provided via telecommunication lines, and software updates received by tape at the customer's business location. Most locations were outside Indiana. Taxpayer reasons that since both the property (software updates) and service components (technical assistance) of the maintenance contracts were received outside of Indiana, the receipts from these sales should not have been subject to Indiana gross income tax.

In support of its position, taxpayer cites IC 6-2.1-3-3, which states:

Gross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign country is exempt from gross income

tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution.

Additionally, Taxpayer offers 45 IAC 1-1-119, a rule that addresses the interstate sale of goods to out-of-state buyers. Relevant to our discussion is the following language:

(1) Nontaxable outshipments

(a) Sales to nonresidents where the seller, upon receipt of a prior order and as part of the contract, ships the goods from a point within or without Indiana to an out-of-state destination. Such sales are exempt from taxation whether shipment is made by the seller in his own conveyance, by his contract carrier or by common carrier, and whether the shipment is made on bills of lading showing the seller, buyer or a third party as the shipper of record.

The Department finds that taxpayer's sales of computer software maintenance agreements were made in interstate commerce. As such, the income from these sales should not have been included in taxpayer's Indiana gross income.

**FINDING**

Taxpayer's protest is sustained.

**IV. Adjusted Gross Income Tax — Interstate Sales**

**DISCUSSION**

Taxpayer protests the inclusion of certain sales in the numerator of the sales factor used in computing its Indiana adjusted gross income tax.

Specifically, taxpayer argues that all receipts from sales of maintenance contracts to out-of-state customers should be excluded from the numerator of its Indiana sales factor. Taxpayer notes that since it has nexus in all states where it has sales, taxpayer must include all sales in the numerator of the sales factor in the state of the purchaser. From these facts, it follows that if these sales were also included in the numerator of taxpayer's Indiana sales factor, double taxation would result.

According to Indiana law, these receipts should not be included in taxpayer's Indiana sales numerator if (1) the transactions represent interstate sales (IC 6-3-2-2(g) and (f)) and (2), the transactions cannot be characterized as "throwback" sales (IC 6-3-2-2(n)).

The Department has previously found that taxpayer's receipts derived from the sale of maintenance contracts represented interstate sales of tangible personal property. Therefore, absent application of the "throwback rule," these receipts should not be included in the numerator of taxpayer's Indiana sales factor.

### **FINDING**

To the extent taxpayer shows the contested sales cannot be characterized as "throwback" sales, taxpayer's protest is sustained.

## **V. Gross Income Tax — Intercompany "Corporate Charges"**

### **DISCUSSION**

Taxpayer protests the assessment of Indiana gross income tax on "corporate charges" between taxpayer and its unconsolidated entities.

Audit discovered that taxpayer received taxable gross income from general and administrative fees charged to unconsolidated subsidiaries. Audit explains:

[Taxpayer] performed centralized functions such as general accounting and administration. Expenses for these functions were allocated to the subsidiary companies based on an estimate of each corporation's use and benefit from the services. Reimbursement for these expenses was accomplished by accounting entries. No actual currency exchange between [taxpayer] and its subsidiaries occurred.

Pursuant to *Information Bulletin* #23, 45 IAC 1-1-96, 45 IAC 1-1-17, 45 IAC 1-1-9, and 45 IAC 1-1-10, Audit assessed Indiana gross income tax - at the high rate - on the general and administrative fees taxpayer charged to its unconsolidated subsidiaries. However, fees charged to its consolidated subsidiaries were eliminated as intercompany receipts. IC 6-2.1-4-6.

Taxpayer, in response, contends Audit mischaracterizes the true nature of the activity occurring between taxpayer and its subsidiaries. Taxpayer argues "the 'corporate charge' does not relate to

any allocation of expenses or cost incurred by the parent company, or represent the transfer of goods or services to a particular subsidiary." Taxpayer goes on to explain:

The corporate charges at issue are not expenses paid or due by each subsidiary to [taxpayer] for administrative functions performed by [taxpayer]. Rather, the "corporate charges" classification emanates from the tracking of employee bonus programs offered by [taxpayer's] various subsidiaries. [Taxpayer's] management philosophy permits the pay-out of bonuses when certain minimum level performance goals are met. These goals are based on the net fair market value, determined by an independent appraisal, of the assets under a respective subsidiary's direction.

### **FINDING**

Taxpayer's protest is sustained.

## **VI. Gross Income Tax — Intercompany Charges Among Affiliated Group Members**

### **DISCUSSION**

Taxpayer protests Audit's disallowance of deductible charges made between members of taxpayer's affiliated group authorized to do business in Indiana.

The transactions at issue involve four (4) members of taxpayer's affiliated group. Affiliate B made sales to Affiliates C, D, and E. Taxpayer reasons that since "the companies were included in [taxpayer's] consolidated gross income tax calculation" the receipts from these sales should be deducted from taxpayer's gross income as intercompany sales.

Taxpayer offers the language of IC 6-2.1-4-6(a), which states:

Except as provided in subsections (b) and (c), each taxable year an affiliated group of corporations filing a consolidated return pursuant to IC 6-2.1-5-5 is entitled to a deduction from the gross income reported on such a return. *The amount of the deduction equals the total amount of gross income received during the taxable year from transactions between members of the group that are incorporated or authorized to do business in Indiana.* (Emphasis added.)

Additionally, IC 6-2.1-5-5(b) states:

Corporate members of an affiliated group that are incorporated in the state of Indiana or are authorized to do business in the state of Indiana may file a consolidated gross income tax return.

In this instance, the four (4) affiliates were included in taxpayer's consolidated Indiana returns. Consequently, taxpayer may deduct receipts from transactions among these affiliates from its Indiana gross income.

### **FINDING**

Taxpayer's protest is sustained.

## **VII. Tax Administration — Penalty**

### **DISCUSSION**

Taxpayer protests the imposition of the ten-percent (10%) penalty. The negligence penalty imposed under IC 6-8.1-10-2.1(e) may be waived by the Department where reasonable cause for the deficiency has been shown by the taxpayer. Specifically:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-2.1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. 45 IAC 15-11-2(e).

Since taxpayer has prevailed, or substantially prevailed, on many of the issues in this protest, the application of the negligence penalty would be inappropriate.

### **FINDING**

Taxpayer's protest is sustained.